

Message Text

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FM AMEMBASSY MEXICO

TO SECSTATE WASHDC 9013

INFO TREASURY WASHDC

C O N F I D E N T I A L SECTION 1 OF 2 MEXICO 15287

E. O. 11652: GDS

TAGS: EFIN MX

SUBJECT: MEXICAN INTEREST RATES

1. IN SPITE OF THE ALMOST 50 PERCENT DEVALUATION OF THE PESO, MEXICAN DEPOSIT INTEREST RATES HAVE NOT BEEN CHANGED. DEPOSIT INTEREST RATES ARE FIXED BY THE CENTRAL BANK AND THERE IS NO COMPETITION BETWEEN BANKS. LENDING INTEREST RATES ARE ALSO FIXED BY THE BANK OF MEXICO, BUT THERE IS MORE ROOM FOR COMPETITION BY VARYING COMPENSATING BALANCE REQUIREMENTS. THE REASONABLY STABLE LENDING RATES CANNOT POSSIBLY CLEAR THE MARKET WHEN INFLATION IS RUNNING 25 TO 35 PERCENT, AND LIKELY TO REMAIN IN THIS RANGE FOR AT LEAST A YEAR. PRESIDENT LOPEZ-PORTILLO HAS CALLED FOR A RESTRUCTURING OF INTEREST RATES, AND PROPOSED OTHER INNOVATIONS AIMED AT SLOWING THE "DOLLARIZATION" OF MEXICO.

2. THE BANK OF MEXICO HAS BEEN UNWILLING TO LET DEPOSIT INTEREST RATES FLOAT, OR TO ADJUST THESE RATES TO A LEVEL THAT WOULD GIVE DEPOSITORS A REAL RETURN ON THEIR INVESTMENTS IN FIXED-TERM DEPOSITS.

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3. THE TRADITIONAL ALLEGIANCE TO FIXED INTEREST RATES

IS APPARENTLY VIEWED BY THE BANK OF MEXICO AS A SIGN OF FINANCIAL STABILITY. THIS IS NOT NECESSARILY VIEWED THE SAME BY THE PUBLIC AS THEY HAVE BEEN MOVING FROM LONGER TIME DEPOSITS TO THE MORE LIQUID INTEREST BEARING DEPOSITS, AND/OR INTO DOLLARS. PESO TIME DEPOSITS MAY NOT INCREASE THIS YEAR, BUT EVEN HOLDING THESE DEPOSITS AT END-'75 LEVELS WOULD BE AN ACCOMPLISHMENT OF SORTS.

4. INTEREST RATES ON THE MOST LIQUID POPULAR SAVINGS INSTRUMENT (FINANCIAL BONDS) PAY 7.5 PERCENT INTEREST ANNUALLY AND CAN BE REDEEMED UPON DEMAND. THIS IS A DECLINE FROM THE 8.75 INTEREST PAID ON THESE INSTRUMENTS IN DECEMBER 1974. THE HIGHEST RATE OF INTEREST PAID BY FINANCIAL INSTITUTIONS IS 12 PERCENT, NET OF WITHHOLDING TAX ON CERTIFICATES OF DEPOSIT WITH SIX-MONTH MATURITIES AND IN DENOMINATIONS OF ONE MILLION PESOS OR MORE. THESE INSTRUMENTS PAID 11.5 PERCENT IN DECEMBER 1975; THE RATE DROPPED TO 10.75 PERCENT IN JANUARY 1976 AND WAS INCREASED TO THE PRESENT LEVEL IN MID-AUGUST 1976. THE RATE FOR FINANCIAL BANKS DID NOT INCREASE AT THIS TIME.

5. IN LIGHT OF A CURRENT RATE OF INFLATION OF 35 PERCENT, WITH THE PROSPECT OF A RATE OF 30 PERCENT CONTINUING THROUGH MOST OF 1977, IT MAY BECOME INCREASINGLY DIFFICULT TO ATTRACT OR EVEN HOLD PESO TIME DEPOSITS. THE RESULT COULD BE AN INCREASING DOLLARIZATION OF THE ECONOMY, PARTICULARLY IF THE PUBLIC ANTICIPATES FURTHER DEPRECIATION OF THE PESO AGAINST THE DOLLAR.

6. THE FEDERAL GOVERNMENT DOES NOT BORROW DIRECTLY FROM THE PUBLIC BUT RATHER DEPENDS ON THE BANKING SYSTEM TO RAISE FUNDS WHICH THE GOVERNMENT BORROWS VIA THE CENTRAL BANK. THE CENTRAL BANK CAN ADJUST THE FLOW OF FUNDS AVAILABLE TO THE GOVERNMENT THROUGH RESERVE REQUIREMENTS BUT DOES NOT BELIEVE IT CAN SQUEEZE THE PRIVATE SECTOR FURTHER AT THIS TIME. SOME LENDING BY THE CENTRAL BANK TO THE GOVERNMENT IS BEING DENOMINATED IN "MEX-DOLLARS." "MEX DOLLARS" IS A RELATIVELY RECENT TERM USED TO DESCRIBE THE DOLLAR DEPOSITS IN MEXICAN FINANCIAL INSTITUTIONS. THESE ARE ALSO BEING USED FOR LOANS TO PRIVATE ENTERPRISES.

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7. A MORE FLEXIBLE INTEREST RATE POLICY IS NEEDED, PARTICULARLY IF THE PESO IS GOING TO CONTINUE TO FLOAT. CURRENT LENDING INTEREST RATES, WHICH CAN BE AS LOW AS 15 PERCENT FOR MORTGAGES AND PRIME BORROWERS ARE NOT CLEARING THE MARKET. PRESUMABLY CREDIT IS BEING ALLOCATED BY SOME KIND OF SELECTIVE ADMINISTRATIVE CRITERIA. FOR EXAMPLE, THE BANK OF MEXICO HAS TRIED TO ENCOURAGE BANKS

NOT TO LEND TO SUBSIDIARIES OF MULTINATIONALS WHICH SHOULD BE ABLE TO BORROW ABROAD. HOWEVER, A MANAGER OF ONE SUCH SUBSIDIARY TOLD US HE WAS ABLE TO BORROW PESOS APPARENTLY BECAUSE HE WAS CONSIDERED A SAFE RISK.

8. FINANCING THE PUBLIC SECTOR DEFICIT IN A NON-INFLATIONARY MANNER IN 1977, AS STIPULATED IN THE IMF PROGRAM, MAY BE DIFFICULT. WHILE LOPEZ-PORTILLO CALLED FOR A RESTRUCTURING OF INTEREST RATES, WE DO NOT YET KNOW WHAT THIS MEANS. WITHOUT A SUBSTANTIAL INCREASE IN PESO INTEREST RATES, THE "DOLLARIZATION" OF THE FINANCIAL SECTOR IS LIKELY TO CONTINUE. IF THESE DOLLARS CAN BE RETAINED IN MEXICAN BANKS, THEY CAN, PERHAPS, FINANCE AT LEAST PART OF THE PUBLIC SECTOR DEFICIT.

9. "DOLLARIZATION" WAS CALLED A THREAT TO MEXICO'S SOVEREIGNTY BY LOPEZ-PORTILLO. IT DOES REDUCE THE ABILITY OF THE MONETARY AUTHORITIES TO RUN A MONETARY POLICY THAT DIFFERS SIGNIFICANTLY FROM THAT OF THE U.S. BUT AS THE DEVALUATION AND SUBSEQUENT EVENTS HAVE DEMONSTRATED, THIS MAY HAVE NEVER BEEN A REAL ALTERNATIVE FOR AN EXTENDED PERIOD OF TIME.

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10. TO COMBAT "DOLLARIZATION", LOPEZ-PORTILLO HAS

PROPOSED THE REINTRODUCTION OF SILVER COINS AND LONG-TERM BONDS TIED TO WORLD PRICES OF BASIC COMMODITIES THE MEXICO PRODUCES. JLP SAID THE "STRONG PESOS" WOULD BE USED FOR TRANSACTIONS. WE SUSPECT THESE WILL SOON DISAPPEAR INTO MATTRESSES, THEREBY DEPRIVING THE ECONOMY OF SAVINGS. THE LONG-TERM BOND PROPOSAL IS FUZZY, BUT APPEARS TO CALL FOR BONDS PAYABLE IN PESOS BUT DENOMINATED IN TERMS OF WORLD MARKET PRICES FOR COMMODITIES SUCH AS OIL OR SILVER. WHILE BOTH TECHNIQUES MIGHT DIVERT SOME PESOS THAT WOULD OTHERWISE GO INTO DOLLAR INSTRUMENTS, WE DOUBT IF THEY WOULD SOLVE THE DOLLARIZATION PROBLEM. IT WOULD SEEM NECESSARY TO LET INTEREST RATES ACROSS THE BOARD REFLECT THE RELATIVE ATTRACTIVENESS OF PESOS VS. DOLLARS. MEXICAN BANKS WOULD PROBABLY BE UNWILLING TO PAY HIGH INTEREST RATES FOR DEPOSITS IN EXCESS OF SIX MONTHS, BECAUSE OF AN ANTICIPATION THAT RATES WOULD DECLINE WITHIN A YEAR OR EIGHTEEN MONTHS.

11. TO MANAGE A FLEXIBLE INTEREST RATE POLICY, THE GOVERNMENT COULD SET INTEREST RATES FOR ITS OWN SECURITIES AND SELL THEM DIRECTLY TO THE BANKS, OR TO THE PUBLIC
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OR CONTINUE TO USE THE CENTRAL BANK AS AN INTERMEDIARY. WHILE THE NEW ADMINISTRATION IS THINKING ABOUT THESE PROBLEMS, WE SUSPECT THAT THEY WILL BE RELUCTANT TO FREE INTEREST RATES JUST AS THEY HAVE BEEN RELUCTANT TO LET THE EXCHANGE RATE FLOAT FREELY. THE REASON WOULD BE THAT THE BANKING SYSTEM WOULD NOT WANT A SYSTEM WHEREBY INTEREST RATES ARE FIXED BY MARKET FORCES, AND THE GOM MAY NOT BELIEVE SUCH A SYSTEM MANAGEABLE.

12. AS A FOOTNOTE, THREE MONTH DOLLAR TIME DEPOSITS PAY 7.5 PERCENT FOR RESIDENTS AND 8.5 PERCENT FOR NON-RESIDENTS. IT IS VERY EASY FOR A MEXICAN TO SAY HIS RESIDENCE IS IN, FOR EXAMPLE, LOS ANGELES, BUT HE WANTS HIS STATEMENTS MAILED TO A LOCAL ADDRESS. THE RELATIVELY HIGHER RETURN ON MEX-DOLLARS COMPARED TO U.S. OR EURO-DOLLARS IS WHAT MAKES THEM ATTRACTIVE. ALSO, THE REAL INTEREST RATE ON DOLLARS IS POSITIVE WHEREAS THAT FOR PESOS IS NOW NEGATIVE. WITH THE MARKET FIXING INTEREST RATES, THE GOM AND/OR BANKS MAY WISH TO DROP THE MEX-DOLLAR. THIS WOULD DEPEND ON LOAN DEMAND FOR THE TWO CURRENCIES. PRESENTLY, THE CENTRAL BANK ABSORBS MOST OF THE MEX-DOLLARS AND RELEND THEM TO GOVERNMENT. NOW, COMPANIES BORROW DOLLARS ONLY WHEN PESOS ARE NOT AVAILABLE, THOUGH THIS COULD CHANGE IF REAL LENDING RATES FOR PESOS AS WELL AS DOLLARS WERE POSITIVE.

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